

TEACHERS' RETIREMENT BOARD

INVESTMENT COMMITTEE

SUBJECT: Real Estate - Real Estate Policies

ITEM NUMBER: 5

ATTACHMENT(S): 2

ACTION: X

DATE OF MEETING: July 8, 1998

INFORMATION: _____

PRESENTER(S): Mr. Pleis

EXECUTIVE SUMMARY

One of the 1997-98 objectives approved for the Investment Branch was to evaluate the appropriate risk and return composition of the real estate portfolio. As a result of this evaluation at the April 1998 Investment Committee meeting, revised real estate policies were submitted to the Investment Committee for review at the May 1998 and June 1998 Investment Committee meetings.

Policies provide parameters that will ensure prudence and care in the management of the real estate portfolio while allowing sufficient flexibility to control risk and capture investment opportunities. The policies are intended to guide the investment activities of the Investment Committee, and are designed to be static in nature. Policies will be returned to the Investment Committee prior to changes being implemented.

At the June 1998 Investment Committee meeting the Investment Committee instructed the Staff to clarify and add additional language to the proposed real estate policies. The clarifications and additions requested by the Investment Committee are underlined and can be found on page six of Attachment 1.

RECOMMENDATION

Staff and Pension Consulting Alliance/E&Y Kenneth Leventhal recommend that the Investment Committee approve the Real Estate Policy Manual by adopting the attached resolution (Attachment 2).

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INTRODUCTION

In accordance with the Investment Management Plan, the California State Teachers' Retirement System (STRS) has established an allocation for investment real estate, an illiquid equity related asset, using internal staff and external specialized professionals. The primary objective for investment real estate is to improve diversification of the overall investment portfolio. The investment real estate portfolio will also have secondary objectives to achieve a rate of return which corresponds to the amount of risk outlined in the real estate portfolio risk/return composite approved by the Investment Committee and to provide a stable cash flow to the investment portfolio.

Investment real estate can be divided into three broad categories of risk: (1) low risk, (2) moderate risk, and (3) high risk. Each risk category contains certain characteristics which have been included as Exhibit 1. STRS investment real estate portfolio will have a target of 75% low to moderate risk and 25% moderate to high risk.

STRS investment real estate portfolio may consist of real estate assets purchased and owned by three main investment ownership structures: (1) direct investments, (2) commingled funds, and (3) securitized investments.

The STRS' Board has established the asset allocation and strategic objectives for the real estate portfolio. The purchase, management and sale of all types of real estate investments are performed by external professionals which are monitored and evaluated by internal investment officers and an external real estate consultant. The internal investment officers operate under the direction of the Chief Investment Officer or designee. The external real estate consultant reports directly to the STRS' Board.

This manual will establish the policies and procedures involved in the management of investment real estate. The policies are designed to set boundaries for expected performance, diversification, and investment structure. The procedures are designed to provide guidelines for the implementation of the approved policies. A flow chart is provided to establish context for the policies and procedures presented.

NOTE: This chart is not available in electronic format at this time.

INVESTMENT REAL ESTATE POLICIES

July 1998

The following represent approved policies to be utilized in the management of the California State Teachers Retirement System's (STRS) investment real estate portfolio. The policies are designed to set boundaries for the expected performance, diversification and investment structure. Policies approved by the STRS' Board cannot be altered without explicit direction from the STRS' Board.

- 1. Laws and Statutes** - The investment real estate portfolio of the California State Teachers' Retirement System is to be invested, managed and sold in a prudent manner for the sole benefit of STRS' participants and beneficiaries in accordance with the Teachers' Retirement law and other applicable statutes. No investment vehicle or activity prohibited by the Investment Resolution adopted by the Board in 1984, as amended from time to time, will be authorized for the investment real estate portfolio.
- 2. Role of Investment Real Estate** - The primary role of the investment real estate portfolio is to provide improved diversification to the overall investment portfolio. Secondary objectives are to generate an enhanced yield to the actuarial rate assumption and to provide stable cash flows. This policy issue was discussed in detail and adopted at the April 1998 Investment Committee meeting.
- 3. Portfolio Risk Composite** - STRS has established a composite risk range for the investment real estate portfolio. A target of 75% low to moderate risk and 25% moderate to high risk was approved. The definition of the different risk levels has been included as Exhibit 1. This policy issue was discussed in detail and adopted at the April 1998 Investment Committee meeting.
- 4. Portfolio Cash Flow** - The projected cash flow for new acquisitions in the low to moderate risk portion of the investment real estate portfolio is expected to meet or exceed the actuarial rate assumption over a five year horizon. Exceptions to this policy must be approved in writing by the Chief Investment Officer.
- 5. Property Type** - The property types used for direct investments in the real estate portfolio are defined as Industrial, Land, Multi-Family Residential, Natural Resources, Office, Retail, Single Family Residential, and other property types as approved in writing by the Chief Investment Officer.
- 6. Geographic Location** - Geographic regions for investing are defined as the location of the individual property. The geographic breakdown is expressed as Mid-West, East, South, West, and International.

7. Investment Ownership Structure - STRS can invest and hold real estate assets in the following three investment ownership structures: (1) direct investments, (2) commingled funds, and (3) securitized investments.

8. Diversification Guidelines - The direct investments contained in the investment real estate portfolio shall have a strategic target and range established for the following diversification criteria: (1) property type and (2) geographic location. The target and range for each criteria are included as Exhibit 2. Purchases or sales shall not be completed for the sole purpose of aligning one specific criteria. Projected rate of return, composite risk profile, and other policies should receive consideration in all transactions.

9. Investment Limitations - Graduated limitations of daily buying and selling cash, securities, and properties for aggregate real estate equity investment portfolio transactions are as follows (including lock box transactions):

Associate Investment Officer	\$ 1 million
Investment Officer I	\$ 5 million
Investment Officer II	\$ 10 million
Investment Officer III	\$ 20 million
Director of Real Estate	\$ 50 million
Chief Investment Officer	\$ 100 million

10. Discretionary Authority - The rejection decision for properties, co-investments, and secondary interests is delegated to staff with the stipulation that all investments are subject to the appropriate due diligence as defined in the real estate procedures.

The approval of major capital decisions including the decision to acquire, finance, refinance, renovate, expand, or sell is delegated to Staff considering the following stipulations:

- A. Due diligence process shall be consistent and appropriate as defined in the investment real estate procedures.
- B. Maximum amount of the commitment should not exceed \$100 million.
- C. A final recommendation report will be presented to the Investment Committee as soon as practical after the transaction is completed.

11. Authorized Signers - Authorization letters which indicate who may sign on behalf of STRS shall be delivered to the appropriate parties. Whenever a change in authorized signers(s) occurs, the effected parties shall be notified within 24 hours in the event of termination and as soon as possible in the event of a newly authorized signer.

- 12. Policy Reporting** - STRS' real estate consultant shall monitor the investment policies and report to the STRS Board as requested.
- 13. Performance Benchmark** - STRS' shall use the NCREIF Property Index to benchmark low to moderate risk real estate investments in the portfolio.
- 14. Annual Business Plan** - The Real Estate portfolio will be managed according to an annual business plan whose main business components will encompass an analysis of the investment environment, a review of the investment strategy, a review of the diversification targets, and a resource allocation budget.
- 15. Portfolio Reporting** - The real estate consultant will prepare and present a portfolio management report on a semi-annual basis. The management report will evaluate STRS' property and regional diversification and property and partnership performance.

Adopted on June 3, 1998

Amended on _____

Investment Real Estate Policies

Definition of Risk Characteristics for Real Estate

Investment real estate can be categorized into a risk and return spectrum comprised of low risk, moderate risk, and high risk. The following table reflects the characteristics of the three categories of risk:

Low Risk

- Expected 4%-6% real rate of return
- Traditional property types (industrial, office, apartment and retail)
- Substantially leased properties at acquisition
- No leverage on the property
- Cash flow from property is the largest component of value
- Large and diverse geographic areas

Moderate Risk

- Expected 6%-12% real rate of return
- Some lease-up risk
- Public securities (REIT, real estate company)
- Moderate leverage (20%-60% loan to value)
- Specialized property types (Timber, Hotel)
- Non economically diversified geographic areas

High Risk

- Expected 12%-20% real rate of return
- Land development
- High leverage (75% or higher loan to value)
- Appreciation largest component of value
- Currency or political (international)

**Investment Real Estate Policies
Diversification Criteria for the Direct Portfolio**

Geographical Location	Range	Target	12/31/97 Actual
• West	30% - 50%	40%	69%
• South	15% - 35%	25%	16%
• East	10% - 30%	20%	6%
• Mid-West	5% - 25%	15%	9%
• International	0% - 10%	0%	0%

Property Type	Range	Target	12/31/97 Actual
• Industrial	15% - 35%	25%	22%
• Apartments	10% - 30%	20%	17%
• Office	30% - 50%	35%	36%
• Retail	15% - 35%	20%	25%
• Other *	0% - 10%	0%	0%

* Other to include Land, Single Family Residential, Natural Resources and Hotels

RESOLUTION
OF THE
TEACHERS' RETIREMENT BOARD
INVESTMENT COMMITTEE

SUBJECT: Investment Real Estate Policies

Resolution No. _____

WHEREAS, the Investment Committee of the Teachers' Retirement Board is responsible for recommending to the Board, investment policy and overall investment strategy; and

WHEREAS, the State Teachers' Retirement System has contracted with Pension Consulting Alliance/EY Kenneth Leventhal (PCA/EYKL) to perform ongoing real estate consulting services; and

WHEREAS, PCA/EYKL and the STRS' Real Estate Staff have reviewed and revised the Investment Real Estate Policies; and

WHEREAS, the Investment Committee adopted the Investment Real Estate Policy Manual as amended, on June 3, 1998; and

WHEREAS, the Staff has incorporated changes to the policies, as directed; Therefore be it

RESOLVED, that the Investment Committee of the Teachers' Retirement Board adopts the Investment Real Estate Policies to incorporate the changes: 1) identification of the benchmark, 2) a requirement for an annual business plan, and 3) a requirement for semi-annual performance reporting by consultant.

Adopted by:

Investment Committee

on _____

James D. Mosman
Chief Executive Officer